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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

STATE OIL COMPANY,

Petitioner,

v.

BARKAT U. KHAN and KHAN & ASSOCIATES, an Illinois Corporation,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY BRIEF FOR PETITIONER

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SUMMARY OF ARGUMENT

Respondent has exaggerated Petitioner's position, and has also based his argument on factual assertions which are not supported by the record. Although Respondent does point out some business concerns which might exist in the franchising field, the effect of the antitrust laws extends far beyond franchising.

The Respondent's argument that maximum prices could become minimum prices is based on a consideration of two separate products as though they were the same item. Petitioner's primary argument that there is no reason to deny manufacturers and wholesalers a right to participate is ignored.

The proposed legislation which was being considered in the statements cited by Respondent provided only for horizontal price fixing, and would have excluded vertical maximum price fixing from per se consideration.

A decision to overrule *Albrecht* will not alter existing franchise relationships, because it will not amend the existing contracts upon which those relationships are based.

The decision in *Albrecht* and the rational for that decision have been undercut by subsequent decisions concerning territorial restraints and antitrust injury.

Respondent's contentions that he suffered antitrust injury are based on a factual conclusion which is not supported by the record.

ARGUMENT

INTRODUCTION

Contrary to Respondent's contentions, Petitioner's argument is limited to vertical maximum price restraints. Petitioner is not suggesting that competitors should be permitted to agree on prices, even maximum prices. Horizontal agreements are *per se* illegal because they restrict competition by some means. But, the purpose and effect of vertical agreements is different. The actions of any one party in a vertical chain directly affect the well being of every other party in that chain. Khan's sales were also State Oil's sales, and directly affected State Oil's profitability. This Court recognized in *Continental T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), that certain vertical restraints are not anti-competitive. That ruling has not opened the floodgates for dramatic changes in rules concerning *per se* liability in other areas.

Petitioner is not suggesting, even in a strictly vertical situation, that the per se rule should be abandoned for agreements limiting minimum prices. As this Court recognized in *Albrecht v. Herald Co.*, 390 U.S. 145, 152 (1968), maximum prices and minimum prices have different consequences. Petitioner's argument is limited to the specific ruling in *Albrecht*, making vertical maximum price fixing per se illegal.

Wholesalers and manufacturers, given the opportunity to limit dealer pricing, may make some poor decisions. However, dealers may also make poor decisions. No matter which party makes the decisions, a poor decision will affect, not only the party making the decision, but every other party in the supply chain. The right to make decisions is the essence of the competitive process, and it

should not be limited to only one level of the chain. Petitioner should not be denied, as a matter of law, the right to enter into an agreement authorizing it to participate in decisions concerning maximum pricing. Any potential for abuse which would exist can be controlled by the rule of reason.

Nor is Petitioner asking for a right to control retailers. The relationship between a wholesaler and a retailer is a matter of contract. The wholesaler has an item which it wishes to sell. To insure maximum sales, the wholesaler may wish to impose a condition that the buyer not offer the item to the public for more than a particular amount. The question then becomes whether the buyer is interested on those terms. The resulting agreement will depend on a number of factors, including how badly the buyer wants that item to sell, and how much he thinks the price limitation will affect his profit.

Respondent makes a number of factual assertions which are either unsupported by or contrary to the record. He claims in a number of places that the price which he paid for regular gasoline was above prevailing market (see, e.g., statement on page 19). This statement ignores the specific finding of the lower court,[1] contains

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[1] The lower court stated (Pet. App. 14a) "But State Oil concedes that its contract implicitly obligated it to suggest retail prices (and adjust its wholesale prices accordingly, to maintain the 3.25 cents margin between wholesale and suggested retail price that the contract guarantees) that were realistic in light of competitive conditions facing Khan. The only evidence Khan presented concerning those competitive conditions was evidence that on sixteen occasions during his operation of the station he had called other dealers and been told that their retail prices were lower than the suggested retail prices fixed

(continued...)

no reference to the record, and is unsupported by the record. Demand curves slope downward and thus a reduction in price typically results in increased sales, no matter what the original price level. The Receiver's increased sales mean nothing.

Khan's statements that his margin was too low are not, and could not be, supported by any reference to the record. No evidence was ever offered concerning the relative level of Khan's margin compared to that of competing stations. His statement that his inability to raise his prices was the reason his business failed is another statement which is not, and could not be, supported by a reference to the record.

Aside from the 16 calls made by Khan to other dealers (over the span of a year) to which the lower court made reference,[2] and found wanting, Khan's entire evidence concerning operation of the station is contained in the report of an expert he retained. (JA 33-42) The report contains no findings or assertion that regular gasoline was over priced, that Khan's margin was low, or that Khan went out of business because he could not raise his prices. Apparently, that expert was either unwilling or unable to state that Khan would have been able to stay

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[1] (...continued)
by State Oil. This evidence falls far short of establishing a genuine issue of material fact concerning a breach of contract. There is no evidence that the dealers were actual competitors of Khan or that the prices charged by those dealers were prices for the same grades of gasoline sold by Khan, which, remember, sold a gasoline that has a well-recognized brand name. The evidence is perfectly consistent with an assumption that State Oil's suggested retail prices were competitively realistic."

[2] See note 1, supra.

in business if he had been permitted to price in the same manner as the Receiver. Thus, Khan's contrary claims are mere speculation.

Nor was any evidence presented to support Khan's statement (page 14) that Khan sought to maximize his volume by lowering the price of regular. At no point did Khan ever state that he had requested or recommended a lower price for regular gasoline.[3]

Nor did the expert claim that the actions of the Receiver increased sales by 20%. He reported a claimed increase of approximately 9% (JA 38-39). In addition, the Receiver did not operate the station at a profit. As State Oil pointed out in its statement of material facts filed with its motion for summary judgment (R43, Statements 14 through 18), the Receiver operated the station for nine months. During that time he showed a loss of $71,000.00. In addition, he depleted $44,000.00 worth of opening inventory, for a total loss of $115,000.00 in nine months. In Khan's response (R49, answers 14 through 18), he denies the figures only to the extent that some of the expenses should not be included because the accounting was on a cash basis and State Oil had included accrued payables. Khan's income tax return is attached to the expert"s report (R65, supporting document 11). Khan also lost money, but his loss was $57,000.00 in a year, less $33,000.00 which were start up costs not incurred by the Receiver, for a total loss of only $24,000.00. Thus, it

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[3] State Oil did attempt to assist Khan. Khan attached to his Memorandum in Opposition to Defendant's Motion for Summary Judgment (R48, ex. "B", "C" and "D") three letters from State Oil reducing his rent. Had Khan so requested, State Oil might have been willing to reduce the suggested price, and thus the wholesale price of regular gasoline.

is clear that the Receiver's experience does not validate Khan's claim that the margin limitations imposed by State Oil accounted for Khan's business failure.

I.

VERTICAL MAXIMUM PRICE RESTRAINTS SHOULD BE JUDGED BY THE RULE OF REASON

In discussing the imposition of per se liability in *Continental T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49, this Court stated that per se rules of illegality are appropriate only when they relate to conduct that is manifestly anticompetitive, and to agreements or practices which have a pernicious effect on competition and lack any redeeming virtue. This Court has also stated that the scope of the per se rule should be narrow where vertical restraints are involved. *Business Electronics v. Sharp Electronics*, 485 U.S. 717, at 724 (1988). The first consideration, in assessing the appropriateness of per se liability, therefore, is whether the agreement or practice is manifestly anticompetitive or will have a pernicious effect on competition. The second consideration is whether the agreement or practice has any redeeming virtue.

A. Vertical Maximum Price Limitations cannot be used to Reduce Competition: The brief filed by Respondent, along with those briefs filed in support of Respondent, clearly identify a specific concern. The argument in those briefs is that the manufacturer or wholesaler will use maximum price limitations to squeeze the dealer's profit. This concern runs from mere reallocation of gross profit for the benefit of the wholesaler, through the gamut to the wholesaler imposing a profit squeeze to put dealers out of business in order either to appropriate

a franchise fee or to take over the good will which has been built up by the retailer.

These briefs make reference only to the franchise-type relationship, and their argument would apply only in that situation.[4] Unless their contracts are exclusive, dealers are entitled to switch brands at any time and could not be squeezed by a wholesaler. The dealer could then make a business decision whether it was worth his while to merely switch brands. General rules of antitrust law are not appropriate for control of franchise relationships.

Of course, in some situations, franchisors could use maximum price limitations to alter the allocation of profit between franchisors and franchisees. But, the relative profitability of franchisors and franchisees is not an issue in antitrust law. Further, a franchisor which engaged in activities that injured its own franchisees, or reduced their ability to compete, would soon put itself out of business, because it would run out of prospective franchisees. A wholesaler or manufacturer has a strong interest in the health of its retail outlets, including the ability of those outlets to compete and to earn an adequate profit. Those retail outlets are its means of reaching consumers. An otherwise legitimate means of competition should not be automatically forbidden by antitrust law simply because it might reallocate profits in certain limited circumstances.

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[4] The Service Station Dealers of America point out in a footnote at page 9 of their Brief Supporting Affirmance, that according to one source more than one-third of the dollars spent on retail transactions flow through franchised outlets. If that is correct, then two-thirds of the dollars are spent in transactions which do not flow through franchised outlets.

If a wholesaler or manufacturer were so irrational that it sought to drive its own dealers out of business, it need not resort to confiscatory maximum price restrictions. A raise in the wholesale price will accomplish the same purpose. Dealers can be given territories which are too small, they can be given sales quotas which they cannot meet, they can be obligated to provide services which the market will not support. In fact, confiscatory price restrictions would be a poor method of achieving that result.[5]

Respondent makes a claim that the maximum will also become a minimum. But, legitimate concern would exist only if the maximum could somehow be used to force dealers to charge a higher minimum than they would otherwise charge. No one has ever suggested a situation under which this phenomenon could occur. It is not the maximum limit which establishes the minimum price. The minimum price is produced primarily by the cost of the product.[6] This is relatively simple to illustrate by asking what happens if the ceiling is removed. Removal of the ceiling will not, of itself, cause the price to go down, although it may permit the price to go up.

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[5] The claimed squeeze is possible only where either the wholesale price or the maximum price is fixed by the contract, and the franchisor has discretion to change the other. If the dealer's margin is negotiated in advance, as in the situation before the Court, and that margin is too low, the parties merely started into business by making a bad bargain. Protecting merchants from bad bargains is not a function of the antitrust laws. In those situations where the franchisor does have discretionary power under the contract, it is obligated to use that power in good faith UCC §1-203; Restatement, Second, Contracts §205.

[6] See 8 Phillip E. Areeda, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* ¶1637c (1989).

Khan claims, however, that his experience demonstrates that a maximum price ceiling sets a minimum. His argument is based on the fact that he purchased two different grades of gasoline from Petitioner.[7] These are two separate products, purchased by different customers. He claims that he could have used the increased profit from the one product to finance a reduction in price of the other product. A maximum price limitation will prevent a dealer from using one product to offset a price reduction for another product. Khan happened to be purchasing both products from State Oil. However, he was also operating a convenience store and was purchasing items, such as milk, beer or cigarettes from others.[8] If Khan had wished to use one of these items to bring people into the station, and wished to increase the price of gasoline in order to offset his loss, State Oil would simply lose volume and income, and, absent a maximum price limitation, would have no effective response. Khan has not demonstrated that his maximum price for any product had become his minimum price for that product.

Khan also contends that if his price had not been limited, he could have reduced the price temporarily and then recouped at some later time. However, he also

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[7] Khan actually purchased three grades, but Khan's argument here rests on the expert's report, which lumped the two higher grades to produce the figures which he used.

[8] According to the figures produced (JA 39-40), Khan's gross margin on sales for items other than gasoline, referred to as ancillary sales, actually amounted to more than 60% of his total gross margin. The same is true for the Receiver's sales and margin assumptions without the maximum price limitations. Those ancillary sales produced a much higher profit margin and may have been of far more significance than gasoline sales.

makes the point that he has no market power. Without market power, it would have been impossible for him to recoup at some later date. When he raised his price to recoup, his customers would immediately shift to other stations.

The lower court found that the agreement between State Oil and Khan would not be illegal if examined under the rule of reason (Pet. App. 6a), and there seems to be tacit agreement with that conclusion. There is no claim of any effect on anyone other than Respondent. The claim is that franchisors will force their franchisees out of business, thereby reducing competition. However, the mere fact that an activity may cause a business failure does not necessarily mean that the activity will reduce competition or is anticompetitive. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.* 429 U.S. 477 (1977); *Atlantic Richfield Co. v. USA Petroleum Co.* 495 U.S. 328 (1990). The antitrust laws were enacted for the protection of competition, not competitors. *Brunswick Corp. v. Pueblo Bowl-O-Matic, Inc.*, 429 U.S. 477, 488. Respondents make no claim of an injury to competition, only to competitors, which in this case is the dealer himself.

B. Vertical Maximum Price Restraints Can be Used to Promote Competition: The primary concern of the antitrust laws is interbrand competition. *Business Electronics v. Sharp Electronics*, 485 U.S. 717, 726 (1988). One of the most effective means of competition is a price reduction. If maximum price restrictions lower prices, they ordinarily enhance competition. To the degree that *Albrecht* reduces the incentive or ability of manufacturers and wholesalers to use price reductions as a means of competition, it restrains competition.

The situation presented when a dealer has acquired local market power is one of the primary concerns presented in many of the commentaries concerning the effect of *Albrecht*. Despite the statements to the contrary in the briefs filed on behalf of Respondent, dealer market power does exist. Dealer market power exists because of territorial restrictions, the existence of highly favored marketing locations which may be created in part by local zoning,[9] or even markets which are not large enough to support more than one retail outlet. This type of market power, however, was not the power on which Petitioner concentrated.

The power on which Petitioner concentrated was the power which was actually created by *Albrecht*. Normally, there are three parties concerned in the distribution process, the manufacturer, the wholesaler and the dealer. Each of these parties is concerned with sales, and each has a real concern with the price at which the product sells. In fact, the margin added on by the wholesaler and the dealer could be considered as part of the cost incurred by the manufacturer in getting its product to market. The same is true for the wholesaler in connection with the dealer's mark up. Yet, the manufacturer and the wholesaler are forbidden to participate realistically in setting this cost. This is the power which is given solely to the dealer by *Albrecht*.

On page 16 of his brief, Respondent makes the statement:

> "State Oil's profitability depends on its ability and willingness to set a wholesale price which is in sync

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[9] Such as the only gasoline station or fast food outlet at a highway interchange.

> with the retail market price—i.e., a price which permits Khan to maximize volume while earning a sufficient profit to remain in business. That is a risk inherent in selling through dealers. If State Oil does not wish to run that risk, it should operate its gasoline stations directly."

The risk to which Khan is referring, is the risk that the dealer will inappropriately price the product, so as to reduce sales. He argues that a manufacturer or wholesaler who does not wish to run the risk should be required to integrate vertically. But, the antitrust laws were not designed to favor vertical integration. They favor competition, not any particular firm structure.

To speak of "market price" of a particular product as though it were an exact thing is to ignore reality. There is a range of market prices for any product, and sales will depend to some degree on the level within that range at which the particular retailer prices the product. The manufacturer or wholesaler who wishes the product priced at the lower end of that range is not attempting to induce an "artificial" price, he is merely attempting to increase sales.

There is a strong incentive to a wholesaler, such as State Oil, to use a price reduction to enhance sales.[10] However, this incentive is reduced when the wholesaler cannot be assured that a price reduction will not simply be pocketed by the dealer. Petitioner is not intending to imply that dealers are any more acquisitive than persons at any other level of the supply chain. However, each merchant does have an inducement to interpret the situation in the manner which will provide him with the largest profit.

[10] This is particularly true in a situation such as this, where the wholesaler also owns the location from which sales are conducted.

There is a feature to Khan's example, which he has ignored. As set forth above, if the dealer was free to use premium gasoline to subsidize regular gasoline, then he was also free to use gasoline generally to subsidize a price reduction in some other product. State Oil would then be subsidizing the product of some other wholesaler. If denied the right to enter into an agreement establishing maximum prices, it could protect itself only by increasing the price to the dealer in order to make this device uneconomical. This is a poor form of protection.

Albrecht denies to the wholesaler and manufacturer the right to enter into an agreement under which the maximum price charged for its products can be limited.[11] This denial affects the economic position of wholesalers and manufacturers, discourages reliance on nonprice restraints, and adversely affects competition and the economy.

Petitioner's primary contention was twofold; first, that there is no basis for a supposition that dealers have more ability to set competitive prices, and second, that manufacturers and wholesalers are affected equally and directly by the retail price. It is in the best interest of manufacturers and wholesalers, as well as in the interest

[11] For example, because the volume of sales at this location was so important to State Oil, it would have an incentive to price Khan below normal pricing to a dealer. Because gasoline prices fluctuate constantly, a set maximum price is impossible. However, it is possible, by means of a margin limitation, to guarantee Khan a margin which he believes is adequate, while at the same time assuring that he will not pocket the price reduction.

of consumers, that the price charged maximize volume in the environment of interbrand competition. Wholesalers and manufacturers should not be denied the right to enter into contracts which enhance the potential for effective sale of their products. Respondent has not responded to this argument.

C. Concern for Prior Decisions Should Not Mandate *Per Se* Treatment in This Case: In the brief filed by Respondent (note 4, page 15), and in other briefs filed in support of Respondent's position, there are references to statements made in support of legislation considered by Congress in 1991, relating to price fixing. Those statements might provide Respondent's position with some support except for two facts. The first fact is that the proposed amendment to the antitrust laws did not pass. Second, and of even greater significance, is that the proposed amendments (H.R. 1470, Congressional Record - House, October 10, 1991, H 7757, and S.429, Congressional Record - Senate, May 9, 1991, S 5605) excluded maximum price. S. 429 specifically provided that vertical maximum resale price agreements are to be considered under the rule-of-reason.

Respondent also contends that franchise investments have been based on the existing interpretation of the antitrust laws. This assertion of a reliance interest is not correct. Franchises are based on contracts. A decision overruling *Albrecht* will not amend those contracts and give franchisors additional rights over existing franchises. Petitioner is merely asking for removal of the *Albrecht* restriction on its right to enter into a contract containing limitations on maximum price levels.

The parties appear to agree that existing authority should be overruled when the development of the law has undercut the conceptual underpinning of a prior decision or where developments have rendered the decision irreconcilable with other legal doctrines. The difference of opinion lies in how that standard applies to this case.

Petitioner had argued that when *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) was overruled by *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977), the rationale upon which *Albrecht* was based was severely undercut. Respondent disputes that position, arguing that "*Albrecht* is more properly characterized as grounded upon the ban on price fixing than upon the *per se* ban on non-price vertical restraints."

Respondent's argument is mistaken. The decision in *Albrecht* was not based on any analysis of an effect on competitive pricing. It was based on the effect which price limitations might have upon the dealer whose prices were being restricted, and as Respondent suggests, upon a reaction to the concept of price fixing, *per se*. But, in *GTE Sylvania*, (433 U.S. at 57), this Court reverted to the standard articulated in *Northern Pac. R. Co. v. United States*, 356 U.S. 1, 5, (1958) and reiterated in *White Motor Co. v. United States*, 372 U.S. 253 (1963), that vertical restrictions are conclusively presumed to be unreasonable, only when those restrictions have or are likely to have a pernicious effect on competition or lack any redeeming virtue. That is, departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic labeling (433 U.S. at 58-59). Each of these statements could be applied as effectively to *Albrecht* as they were to *Schwinn*.

Respondent argues that *Albrecht* is based on an objection to price fixing. This is quite possibly correct, but is formalistic labeling rather than realistic appraisal. Per se liability in *Albrecht*, as in *Schwinn*, was based on a standard which has been rejected by this Court, and is no longer applicable.

II.

RESPONDENT DID NOT SUFFER AN ANTITRUST INJURY

Khan's claim that he suffered antitrust injuries is based on his statement (page 19) that the suggested pump price of regular gasoline was higher than the prevailing market and that he could not profitably compete on regular gasoline. As stated above, there is no support in the record for these statements.

Khan then goes on to state that he lost money because he could not increase his prices o. premium gasoline to offset losses on regular gasoline. He implies in the way he makes this statement that he was losing money on regular gasoline. More precisely, the claim is that he would lose margin per gallon by reducing the price of regular gasoline.[12] Whether he would actually lose money by doing so would depend on whether increased sales (both of gasoline and in the convenience store) were

[12] The receiver earned an average margin of $0.0382 per gallon (JA 39) during the time selected for the study, contrasted with the $0.0325 permitted Khan. Therefore, although some customers paid more and some paid less, on average a customer who purchased gasoline at this station paid more for his gasoline than he would have paid under the restrictions imposed on Khan.

adequate to make up for the lost margin. Khan's claim is that this is the reason he lost his business, a claim which has no support in the record. Khan attempts to make claims of antitrust injury, based on statements contained in *Albrecht* and *Atlantic Richfield* about the nature of possible problems created by maximum vertical price restraints. There is, however, no claim that customers were deprived of any services which would have enhanced the value of the products he was selling, or that the agreement in any way advanced the position of other gasoline dealers. The only claim which has any support in the record is his claim that he could have earned more money by increasing the price of premium gasoline. Every other statement is pure speculation.

Khan was contesting a motion for summary judgment, and was obligated to present sufficient evidence to show the existence of any injury which he claimed. *Celotex Corp. v. Catrett*, 477 U.S. 317, 106 S.Ct. 2548, 91 L.Ed. 2d 265 (1986). If he wished to advance these contentions to provide antitrust injury, he should have done so.

Antitrust injury does not arise for purposes of §4 of the Clayton Act until a private party is adversely affected by the aspect of the defendant's conduct which makes it anticompetitive. *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990). Even assuming *arguendo* that the margin limitation agreed upon between State Oil and Khan drove Khan out of business, Khan has demonstrated antitrust injury only if it is an anticompetitive act to drive your own dealers out of business. Certainly competing stations did not suffer. Except in the short term, they did not gain either. The station was still there. If it was a viable location, it would be operated by someone else, possibly by someone who would operate it more efficient-

ly than Khan. If it was not a viable location, then it was doomed from the start.

The argument which Khan is making suggests that although no antitrust injury arises from driving your competitors out of business, it does arise from driving out your own dealers. That is, there is an antitrust injury if you drive out your own dealers by means of pricing limitations, but none if you drive them out by merely terminating them, or creating unfortunate territorial restrictions.

There is only one possible basis for an argument that a result produced by pricing restraint would produce antitrust injury, whereas that same result produced by some other provision such as territorial restraints would not; that pricing restraints trigger *per se* liability, whereas other vertical restraints do not. The argument that actions which are per se violations automatically generate antitrust injury was negated by this Court in both *Brunswick* and *Atlantic Richfield*.

What this argument demonstrates is that the development of the law, not only concerning other types of vertical restraints, but also antitrust injury, has undercut the conceptual underpinning of *Albrecht*, and that subsequent developments have rendered *Albrecht* irreconcilable with other, more current, legal doctrines.

CONCLUSION

The conceptual underpinning of *Albrecht* has been so seriously undercut by subsequent decisions concerning both territorial restraints and antitrust injury, that the decision is no longer supportable. There is no reason, based on competitive factors, to deny manufacturers and wholesalers the right to enter into contracts which limit the maximum price which can be charged for the products which they are selling. They are as influenced by the market, and as eager to respond to that market as are retailers. Petitioner respectfully prays that this Court reverse the decision of the Court of Appeals and reinstate the decision of the district court in this cause.

Respectfully submitted,

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